Can U.S. Farm Subsidies Be Bought Out?*

David Orden

ABSTRACT

Achieving substantial agricultural trade liberalization has proven elusive in the Doha Round. This paper examines policy reforms the United States might adopt to facilitate progress. The focus is on whether decoupling can be made more convincing through a long-term buyout that would end farm subsidies. Buyouts have not been feasible in the past but recent reforms for several specialty crops provide evidence of what might be done and the conditions under which it occurs. Although the political-economy conditions may not be conducive to such a buyout yet, estimates are provided of the potential cost of a buyout of the main U.S. farm support subsidies of direct fixed and counter-cyclical payments.

Corresponding Author:

David Orden
Senior Research Fellow
Markets, Trade and Institutions Division
International Food Policy Research Institute (IFPRI)
2033 K Street, N.W.
Washington D.C. 20006

Phone: (202) 862-8160
Email: d.orden@cgiar.org

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As the Doha Round of WTO negotiations unfolds, achieving substantial liberalization of agricultural trade remains elusive. One reason is that just a few years after the WTO Uruguay Round agreements put a set of multilateral trade and subsidy rules in place for agriculture, the level of U.S. farm subsidies rose sharply. Simultaneously, some developing countries with smaller fiscal resources responded by increasing border protection to shield their domestic farmers from declining agricultural prices. Continuation of high subsidies in developed countries matched by high tariffs in developing countries remains a possible result of domestic and WTO policy decisions. A more desirable outcome would be the globally efficient and welfare-enhancing solution of low subsidies and low protection.

In this paper I explore a policy option that the United States might use to reduce the long-run cost of subsidies and facilitate the liberalization of agricultural trade, while providing substantial transition support to farmers. The focus is on whether reforms to decouple farm support programs, which are supposed to reduce their production- and trade-distorting effects, can be made more convincing through a buyout that would end farm subsidies. Buyouts have not been feasible in the past but recent reforms for several specialty crops provide evidence of what might be done. Estimates are provided of the potential cost of a buyout of the main U.S. farm support subsidies of fixed direct and counter-cyclical payments. A buyout of this type should be on the agenda in discussions of the next farm bill.

Reforms of Agricultural Policies

The "Cash Out" Shift Away from Market Interventions

There has been substantial reform of farm policies within the developed countries since the 1930s New Deal price supports and supply control measures were introduced in the United States or the Common Agricultural Policy (CAP) was later inaugurated to provide a unified price support regime in Europe. Orden, Paarlberg and Roe (1999) call the U.S. farm policy reforms that have proven feasible over the past half century largely a "cash out" in which direct payments to farmers from taxpayers have replaced the support programs that earlier propped up commodity market prices. The price support programs required various interventions in markets to be operational, including tariff or quota protection, government stock accumulations, domestic supply controls, and/or use of export subsidies. As the cash out reforms have proceeded, the New Deal programs remained in effect only for a group of specialty crops, particularly peanuts, tobacco and sugar.

The cash out reform of U.S. farm policy began in the 1960s. It took a substantial step forward in the 1985 farm bill, which lowered minimum price support guarantees (loan rates) while providing cash ("deficiency") payments for a large portion (fixed yields on 85 percent of "base" acreage) of the output of supported crops whenever market prices fell below legislated "target price" levels. Eligibility for the cash payments required production of specific crops. To control fiscal costs a voluntary Conservation Reserve Program (CRP) was initiated and annual land idling was required. The cashed out U.S. support program with payments on limited output combined with annual land idling authority was exempted from WTO expenditure disciplines under the Uruguay Round blue box, while the CRP is a green box policy.

The 1996 U.S. farm bill went further in the cash out direction. Key new reforms were to suspend the authority for annual land set-asides and production of specific crops as conditions for payment eligibility and to replace the deficiency payments, at a time of high market prices, with fixed annual payments based on past production. Even the loan rate minimum producer prices were to be guaranteed with payments ("loan deficiency payments") instead of by government stock-holding interventions.[1] Thus, the 1996 policies were more decoupled from production and caused less market distortions than previously. The 1996 regime ostensibly paved the way for the United States to abandon the blue box in the WTO. But when market prices of farm commodities fell after 1996, support to farmers was supplemented with additional payments. Initially these "emergency" payments were reported to the WTO as non commodity specific *de minimis*. The 2002 farm bill then legislated new counter-cyclical payments tied directly to the levels of market prices, but again not to current crop production.[2] With this added support enacted, the United States began to argue in the Doha Round for relaxation of the blue box criteria to include the counter-cyclical payments instead of seeking its elimination.[3]

In the European Union, a similar cash out of price support interventions has occurred, from higher initial levels and starting later chronologically than in the United States.[4] Through the 1980s, intervention prices above world market levels made the EU dependent on direct export subsidies. The 1991 McSharry reforms began a cash out, with direct payments offered as compensation for lower intervention prices and acreage idling required to limit costs. It was this reform, followed by the Agenda 2000 and 2003 CAP reforms, that allowed the EU to sharply reduce its use of export subsidies and paved the way for the WTO July 2004 Doha Round framework agreement to call for their eliminate by a date certain. The 2003 reforms took the decoupling step of introducing whole farm payments for which production of specific crops will not be required. Although there are messy implementation rules allowing some support payments still tied to production, to an extent the EU with its whole farm payments has moved decoupling past the U.S., which retains its price-linked counter-cyclical payments.

Might Farm Program "Buyouts" Facilitate Trade Liberalization

A cash out is a gradual and partial reform process that reduces the market intrusiveness of farm programs over the long run by offering their beneficiaries a continuous stream of cash compensation payments. The gains for those countries pursuing a cash out are fewer market distortions, fewer production restraints, and more competitive export pricing. The extent to which cash out measures have decoupled farm support from production decisions and trade

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[1] The idea of making loan deficiency payments to provide producer price guarantees while allowing market prices to fall below the loan rates was first introduced on a limited basis in 1985.

[2] Farmers were also allowed to update their base of eligible output and direct payments were extended to oilseeds. Westcott, Young and Price provide a summary of the provisions of the 2002 farm bill. Orden (2003) provides a political-economy assessment of its enactment.

[3] The change proposed was that payments otherwise eligible for the blue box be extended from those made "under production limiting programs" to also include those that "do not require production."

[4] Swinbank (2004) provides a concise appraisal of the EU reform process since the late 1980s.

effects remains under scrutiny.[5] Even when decoupled, a cash out entails an open ended commitment to support payments. Thus, cash outs have drawbacks. Dirty decoupling under a cash out and the ongoing character of the subsidization remain obstacles to trade liberalization.

Alternatives to the cash out approach for ending intrusive farm program interventions, or even for ending a cash out itself, can be distinguished based on the speed of reform implementation and whether or not compensation is provided to beneficiaries of the programs (see Figure 1). A buyout is a quick termination of support entitlements, made politically palatable through significant but temporary compensation up front, in the form of a large cash windfall. A squeeze out is an incremental reduction in the market intrusiveness and generosity of farm programs, managed slowly enough to avoid triggering a defensive backlash from lobby groups representing subsidy-dependent farmers, yet significant enough over time to reduce distortions and costs, and to inspire voluntary non-participation by market-oriented commercial farmers. A cutout is a quick termination of all program support entitlements without compensation. None of these alternatives to a slow compensated cash out has proven feasible on a large scale in the United States or Europe. But could a buyout bring an end to domestic farm support programs in developed countries, thus reducing the long-run cost of farm programs and advancing the prospects for a liberalized agricultural trade regime, while providing transition support to farmers?

Figure 1. Alternative Reform Strategies

Compensation	Speed of Implementation	
	Slow	Fast
Yes	Cash out	Buyout
No	Squeeze out	Cutout

Source: Orden, Paarlberg and Roe (1999).

Recent Buyouts: Peanuts and Tobacco

A number of recent policy reforms around the world have provided buyouts. In the United States, contrasting recent policy outcomes among the historically similar peanut, tobacco and sugar support programs provide some evidence about the conditions conducive to a buyout and its consequences. Very briefly, the 2002 restructuring of the peanut program included a buyout of production quota rights together with new direct and counter-cyclical payments. The 2004 tobacco buyout ended quotas and eliminated the loan rate program without implementing new

[5] For example, one exception to the decoupling of payments in the 1996 and 2002 farm bills is that production of fruits and vegetables is restricted on program base acreage. In a WTO challenge to the U.S. cotton program by Brazil, the dispute settlement Appellate Body concluded that restricting production of fruits and vegetables (an alternative crop for cotton acreage in California in particular) is inconsistent with the WTO green box criteria.

payment mechanisms. In contrast, there has been relative lack of reform of the support program for sugar.[6]

One lesson from the two recent reforms is that narrowly defined benefits, specifically production quotas, may be easier to buy out than broader support policies. Binding quota rights were bought out both for peanuts and tobacco, whereas sugar marketing allotments that are only intermittently binding have not been bought out.

The onset of reform aligns closely with shrinkage of the benefits obtained by participants in the old program. The pressure from reduced quotas and revenue was most severe for tobacco and the tobacco buyout most complete. Unique dimensions with respect to tobacco also explain the more complete buyout of tobacco support compared to peanuts. Domestic tobacco producers had been less successful than peanuts or sugar producers in securing restrictions on imports to protect their quota rents. The substantial health-cost-related transfers financed by manufacturers, importers and consumers in the 1998 Master Settlement Agreement are also unique to the tobacco industry. This set the precedent for financing the tobacco buyout with specific assessments instead of general tax revenue. Had this precedent not existed, the higher cost of the tobacco buyout ($9.6 billion) compared to peanuts (about $4 billion over 10 years including ongoing payments) might have blocked its enactment. The health issues associated with tobacco consumption also contributed to the outcome of full elimination of the support programs for producers. In contrast, peanut producers were able to align ongoing support with the cash payment programs for other crops.

Consumers have influenced whether buyouts have occurred to the extent that their demand behavior contributes to declining benefits under the quota program. But the political condition necessary for a buyout appears to be the emergence of substantial support for a reform among producers. Emergence of such opinion is obviously related to the shrinkage of benefits. Producers excluded from having quotas also tend to favor reform. This is especially evident in the case of producers of what were "additional" peanuts, who gained in 2002 by becoming eligible for a stronger support program. The opinion among producers in favor of reform does not have to be unanimous. In both the peanut and tobacco cases, minorities of producers in high-cost production regions opposed elimination of the location-specific quotas.

It is also the case that while a buyout may be conducive to liberalization of trade policy, the peanut and tobacco buyouts benefited domestic not foreign producers. The United States was already a net peanut exporter of additionals—imports were artificially drawn in primarily because of the high domestic price under the quota program. In the case of tobacco, total U.S. output is likely to rise with the buyout, displacing imports.

In terms of compensation, the buyout payments have been quite lucrative in the recent reforms, even given the circumstances of declining benefits to quota owners that have provided the reform triggers. The quota buyout payments for peanuts and the quota and total (quota owner and

[6] For discussion of the recent policy reforms see, for example, Brown and Thurman; Brown and Snell; Dohlman, Hoffman, Young and McBride; Orden and Diaz-Bonilla; Snell;Tiller, Snell and Brown; and Womack (2003, 2004a, 2004b).

operator) buyout payments for flue-cured and burley tobacco are compared to a seven-year average (1995-2001) of pre-buyout poundage quota rental rates in Table 1.

For peanuts the lump-sum payment of $0.55/pound made available in the 2002 farm bill is equivalent to an infinite stream of payments of $0.026/pound at a 5 percent discount rate. This is about 70 percent of the average of past quota rental rates. Alternatively, the quota buyout payment is equivalent to the average of annual past rental payments, discounted at 5 percent, made for a period of 24 years. The buyout payments exceed this potential future payment stream to the extent that domestic peanut prices might have fallen had the earlier program continued. Likewise, the buyout payments exceed this future rental revenue stream under the old program if the quantity eligible for sale in the domestic market would have continued to decline under its continuation.

Table 1. Value of the Peanut and Tobacco Buyouts (per pound of quota)

	Peanuts	Flue-cured	Burley
7-Year Simple Average Quota Rent (1995-2001)	$0.037	$0.471	$0.411
		$7.00 Tobacco Buyout	
Quota Buyout Present Value	$0.550	$5.675	$5.675
Equivalent Infinite Annuity	$0.026	$0.270	$0.270
Years for Average Rent	24	16	21
		$10.00 Tobacco Buyout	
Quota Buyout Present Value	--	$8.108	$8.108
Equivalent Infinite Annuity	--	$0.386	$0.386
Years for Average Rent	--	34	56

Source: Womach, Jasper, “Comparing Quota Buyout Payments for Peanuts and Tobacco,” Congressional Research Service Report RS 1642, October 2003, and author’s calculations. Present values, infinite annuities and years for average rent are based on a 5 percent discount rate.

For tobacco, the ten-year stream of annual buyout payments is first discounted back at a 5 percent rate to an equivalent initial lump sum. This reduces the payment from the nominal $7.00 to $5.68, as shown in Table 1. The lump sum payment is equivalent to an infinite stream of payments of $0.27, about 57 percent of the average of past quota rentals for flue-cured tobacco and about 66 percent for burley tobacco. The lump sum payment is more than double the private market prices that had prevailed for sales of quota rights before the reform.[7] It is equivalent to discounted average rental payments for 16 and 21 years for flue-cured and burley tobacco, respectively. Including the $3 payments to growers (also discounted to an up-front lump sum), raises the equivalent number of years of past rentals covered (to 34 and 56 years for flue-cured

[7] Alston and Sumner (2004) conclude that agricultural quota-right purchase prices are usually heavily discounted.

and burley, respectively). Again, the buyout is more lucrative for producers to the extent that tobacco prices or quota allocations were likely to have continued to fall under continuation of the old program.

The Debate over Larger Buyouts

As the cash out of farm support policies for most crops has occurred, buyouts have on occasion been proposed, either as a means to facilitate adjustment out of agriculture or as compensation for elimination of a support program. These buyouts have not been adopted because the main thrust of farm support programs has been to dampen pressure for adjustment not to facilitate it or speed it up.[8] The time has largely passed when farm poverty or large migrations out of agriculture provided a rationale for adjustment-dampening policies, and their effectiveness can be questioned. Yet the argument that farm policy should facilitate adjustment out of the sector is still not widely held. Nor has reform gone so far as to eliminate the main support programs and offer buyout compensation.

Bond Schemes in the EU

A "bond scheme" for transforming EU CAP policies was introduced by Tangermann in 1991 (Swinbank and Tranter, 2004; Daugbjerg and Swinbank, 2004). The initial bond proposal was made before the EU adopted the 1992 McSharry reforms. As characterized recently by Swinbank and Tangermann (2004), the proposal incorporates six steps:

1. Decouple crop payments from current land use
2. Extend this principle to livestock
3. Decouple payments from land and attach the entitlements to individuals
4. Limit the duration of payments to, say, ten or twenty years, and (possibly) make payments degressive over time
5. Definitively fix the future level of payments, and
6. Transform payment entitlements into bonds.

Swinbank and Tangermann recognize that the EU cash out reforms by 2003 largely accomplish their steps 1 and 2. Steps 3-6, they argue, would add two advantages. First, these steps would allow land prices to fall to facilitate structural adjustments in production. Second, they would create certainty about future payments, while at the same time bringing the payments to an eventual end.[9]

The Tangermann bond scheme was an innovative proposal when it was first presented. Whether the bond scheme proposal would be a buyout or a delayed cutout depends on the level of associated payments. Swinbank and Tangermann center their discussion on payments starting at the level of the existing EU farm programs. They argue this would avoid putting additional pressure on the EU budget. But guaranteed payments at existing levels for 10 or even 15 years is

[8] Orden, Paarlberg and Roe (1999) and De Gorter and Baffes (2004) review several past buyout proposals.
[9] Swinbank and Tangermann (2004) argue that issuing of tradable bonds to a finite-length stream of fixed payments would create a flexible asset for the beneficiaries and "lock-in" the policy reform since payments "could not be altered without impacting on the wealth of bondholders who are no longer the original farm recipients" (p. 65).

not very lucrative for producers by the standard of the quota buyouts for U.S. peanuts or tobacco. Nor are some of the other conditions conducive for a buyout particularly strong for EU farm payments in 2004. Their remains ambiguity in the 2003 CAP reforms so the benefits being bought out by the bonds are not yet narrowly defined. A sharp diminishing of benefits under the existing programs is not evident. There is no groundswell of calls for a buyout from producers (although producers are not opposed to the scheme according to survey analysis undertaken by bond researchers (Tranter et al. (2004)). For these reasons, the prospects may be low for adoption of a bond scheme in the near term. Yet, introduction of such bonds, especially with declining annual payments over an agreed implementation period, could provide a convincing domestic subsidy counter-part to phasing in substantial tariff reductions through the WTO.

Cost of a Larger Buyout of U.S. Farm Payments

So far there has not been a convincing buyout proposal for the main farm support programs in the United States.[10] The fixed payments adopted in the 1996 farm bill provided a windfall to farmers in a year of high market prices, but that legislation failed to ensure a buyout in three respects: a budget baseline remained in place for future farm program spending, the permanent farm program legislation from 1949 and related acts was retained, and the 1996 farm bill took no other steps to bind the actions of a future Congress. When farm commodity prices fell, the next Congress quickly stepped in with additional payments.

A buyout of the 2002 U.S. farm programs could focus on the fixed direct payments, the counter-cyclical payments, and/or the loan rate price guarantees. The fixed direct payments are a narrowly-defined benefit which increases the feasibility of a buyout. Bringing their eventual elimination would ease concerns about continued subsidization but would accomplish the least economically or institutionally. This is because either the fixed payments or a buyout replacement are relatively decoupled and are largely a WTO green box policy.

A buyout of the counter-cyclical payments would accomplish more, since these payments are a particularly contentious form of decoupling likely to have some production stimulating effects. A buyout of counter-cyclical payments would let the United States abandon the WTO blue box, potentially allowing simplification and improved transparency of the WTO rules for agriculture. The value to producers of counter-cyclical payments is not as certain as the fixed payments under the 2002 farm bill, but there is an upper bound because the payments are made on fixed quantities and at per-unit levels no greater than the difference between the target price and the sum of the loan rate and per-unit fixed direct payment rate for each commodity. Farmers who succeeded politically in building the counter-cyclical payments into the 2002 farm bill to address what they viewed as an inadequate safety net in the 1996 legislation are not clamoring to eliminate these new payments. But government fiscal deficits that had eased when the 2002 farm bill was enacted have increased again. So farm program spending will be under scrutiny.

Table 2 provides information on the potential costs of several buyout options. Results are shown separately for a buyout (for all commodities aggregated) of the fixed direct payments, the maximum possible counter-cyclical payments, and the expected counter-cyclical payments as

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[10] Blandford and Boisvert (2004) make a recent call for a buyout of land asset values to facilitate an end to existing U.S. farm support program, which they characterize as still being to "think the unthinkable."

evaluated by USDA. Under the 2002 farm bill, for example, fixed direct payments over six consecutive years (crop years 2002-2007) have an average annual value of $5.292 billion and a discounted present value (at a 5 percent discount rate) of $28.198 billion (row 1).

Buyout payments shown in Table 2 are assumed to be made in equal nominal installments over 10 years, as in the tobacco case. The buyout costs shown in row 2 are those required to compensate for annual payments made for 25 years at the average level of the 2002 farm bill—this is roughly consistent with the buyout compensation provided for peanuts and tobacco. The nominal values of annual payments for which these costs are equivalent as an infinite annuity are shown in row 3.

Table 2. Possible Buyouts of the Main U.S. 2002 Farm Bill Support Payments

	Fixed Direct Payments	Counter-cyclical Payments	
		Maximum Possible	Projected Level
	…………billion dollars………….		
2002 Farm Bill Payments (crop years 2002-2007)	5.292 (average) 28.198 (lump sum)	7.302 (average) 38.787 (lump sum)	3.505 (average) 18.303 (lump sum)
Buyout Payments Over 10 Years Equivalent to Annual Payments at 2002 Farm Bill Level for 25 Years	9.659 (annual) 78.311 (lump sum)	13.328 (annual) 108.065 (lump sum)	6.398 (annual) 51.870 (lump sum)
Infinite Annuity Equivalent of Buyout Payments	3.729 (annual)	5.146 (annual)	2.470 (annual)

Note: Fixed direct payments and projected counter-cyclical payments are based on the president's 2006 budget. Estimate of maximum counter-cyclical payments is from calculations provided by ERS/USDA. Buyout payments are assumed to be made in equal installments over 10 years. Present values and infinite annuities are based on a 5 percent discount rate.

A buyout of the fixed direct payments along the lines shown nearly doubles the annual expenditure (from $5.292 billion to $9.659 billion) that would have to be made for ten years compared to expenditures each year under the 2002 farm bill. It almost triples the present value of the payments under the 2002 bill (from $28.198 billion to $78.311 billion). This buyout raises short-term costs, but the annual value of equivalent payments in perpetuity ($3.729 billion) is less than the average annual payment the 2002 farm bill will deliver during 2002-2007. A buyout of the maximum possible counter-cyclical payments is more costly, while a buyout of their projected value has a lower cost than for the fixed direct payments.

Overall, buying out farm support payments raises short-term budget costs but reduces expenditures in the long run. Drawing on the recent buyouts for peanut and tobacco quotas, the buyout illustrated in Table 2 provides a long transition period and relatively high level of compensation. Shorter, sharper buyouts could be undertaken. In either case, short-term costs must rise in order for a buyout to provide compensation for the loss of payments further in the future. This can still be considered a good deal by taxpayers (who gain in the long run) and farmers (who receive a short-term boost).

If farm subsidy payments were to be bought out, there is also an issue of whether any buyout could be enforced. The record from the post-1996 increase in support shows new expenditures can arise. But several steps can be envisioned that would improve the prospects for adherence to a buyout. The first would be to eliminate the permanent legislation for farm support programs. A WTO agreement built around a buyout of U.S. counter-cyclical payments might also provide an enforcement mechanism.

Stronger steps could also be taken. Contracts for buyout payments could require that the acreage for which the payments were bought out (and the output from that acreage) be ineligible for future support legislated by Congress. To ensure compliance, such contracts might be structured similarly to those by which some farmers sell their "development rights" to state and local governments for the different purpose of their land remaining in rural condition or agricultural use. The state governments have devised binding legal criteria to ensure compliance from the contract beneficiaries who have sold their development rights.

Can There Be a Buyout in the Next Farm Bill?

Achieving beneficial multilateral liberalization of agricultural trade has remained elusive. This paper has explored a long-term buyout that would end farm subsidies as a policy option the United States might use to facilitate progress while providing substantial transition support to farmers.

The differing recent policy outcomes among the historically similar peanut, tobacco and sugar support programs provide some evidence about the conditions conducive to a buyout and its consequences. Narrowly defined benefits, specifically quota rights, may be easier to buy out than broader support policies. The onset of reform aligns closely with a sharp shrinkage of the benefits obtained by participants in the old program. The political condition necessary for a buyout appears to be the emergence of substantial support for reform among producers, which is related to the shrinkage of benefits. While a buyout may be conducive to liberalization of trade policy, the peanuts and tobacco buyouts have benefited domestic not foreign producers.

In terms of compensation, the payments have been quite lucrative for the buyout reforms that have occurred, especially given the circumstances of declining benefits to quota owners that have provided the reform triggers. For peanuts the lump-sum payment of $0.55/pound is equivalent (at a 5 percent discount rate) to previous average quota rental payments for a period of 24 years. For tobacco, the ten-year stream of owner buyout payments is more than double the private market prices that had prevailed for sales of quota rights before the reform. It is equivalent to discounted average rental payments for 16 and 21 years for flue-cured and burley tobacco, respectively.

There has not yet been a convincing buyout proposal for the main supported farm commodities and the political environment may still be far from prompting such a reform. Yet such a reform should be on the agenda in discussions of the next farm bill. Buyouts of the fixed direct and counter-cyclical payments along lines similar to the peanut or tobacco quota buyouts would nearly double the annual expenditures that would have to be made for ten years compared to expenditures each year under the 2002 farm bill, and almost triple the present value of those payments. Thus, a buyout will raise short-term costs, but the equivalent annual payments in perpetuity will be less than the 2002 farm bill has delivered in recent years. Such a buyout is an investment in the future. It provides long-term savings for taxpayers, enhanced transition support to farmers, and a basis on which to pursue more open global agricultural markets.

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